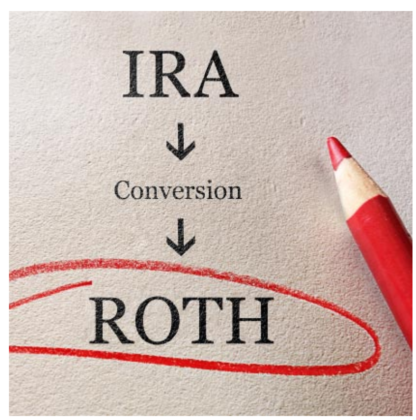
Serial Roth Conversions: The Actual Numbers and Benefits of Multiple Strategies

We have heard a lot about the benefits of serial Roth conversions, but will small serial Roth conversions really do anything? Let's take a closer look.

When it comes to choosing an IRA, the conventional wisdom is to use a Roth IRA if tax rates are expected to rise in retirement and choose the traditional IRA if they are expected to fall in retirement.



However, you can't be too sure of future tax brackets, particularly in an election year and with the sunsetting of TCJA in 2025. So one should consider placing part of those assets in a Roth account as enabling "tax diversification" in retirement, regardless of anticipated future marginal tax rates.

The big question, however, is how to go about it? We have heard a lot about the benefits of serial Roth conversions, but will small serial Roth conversions really do anything? An illustration could go a long way to proving the value of a Roth IRA to yourself—and possibly to doubtful clients.

Benefit of serial Roth conversions

Per the chart in Figure 1 below, an investor who has $500,000 in her traditional IRA at age 55 will have $1,026,744 by the time she turns 88. This is assuming a growth rate of five percent and that she does no conversions.

If the same investor performed a $17,500 Roth conversion per year beginning at age 55 for 33 years, she would have $336,158 in her traditional IRA at age 88, but $1,405,285 in her Roth IRA! This is assuming a five percent net rate of return. Thus, by doing annual Roth mini-conversions, this investor will have $700,000 more in investments, and most of that will be in a tax-free Roth account.

It is important to note that a strategy like this may not be as effective if tax rates were to decline, but who thinks that is going to happen? Perhaps the chart below will give a better perspective of what is going on here.

Figure 1: Outcome of Serial Roth Conversions of $17,500 Per Year

Age	Traditional IRA (No Conversion)	Traditional IRA (Converting $17,500/year)	Roth IRA (Funded w/ $17,500 per year)
55	$500,000	$500,000	$0
65	$814,447	$583,329	$221,471
71	$1,091,437	$656,731	$415,825
88	$1,026,744	$336,158	$1,405,285

Source: Prudential

Example #1: Traditional IRA with no Roth conversion

At age 55, the investor has $500,000 in her traditional IRA. She chooses not to convert any monies to a Roth IRA but allows the tax-deferred account to grow at a five percent rate per year. Her account grows by $314,447 over the span of 10 years without contributions. At age 65, she has $814,447.

At age 71, her traditional IRA balance is $1,091,437. She is then forced to take RMDs of about $41,000 per year which will be taxed at her ordinary income rate of 24%. She will then have a balance of $1,026,744 by the time she turns 88. Keep in mind this money is taxable at her ordinary income rate as well, since it is all in traditional IRAs.

Given the 24% tax rate, the income taxes paid by the investor is $256,538. In addition, the beneficiary will have to pay $238,366 upon her passing away because of the large traditional IRA balance and the recently enacted Secure Act, which forces most non-spouse beneficiaries to take withdrawals within 10 years.

Example #2: Traditional IRA while converting $17,500 to a Roth IRA

The two columns on the right go hand-in-hand. If the same investor converted just $17,500 per year from her traditional IRA to her Roth IRA for 33 years, she would have two accounts totaling $1,741,443 ($336,158 in her traditional IRA and $1,405,285 in her Roth IRA).

By the time our investor is required to take distributions at age 72, she has account values of $656,731 in her traditional IRA and $415,825 in her Roth IRA, totaling $1,072,556. This traditional IRA balance is $434,706 less than the example with no conversion, but there is a Roth IRA of $415,825, where none would have existed before. As usual, the monies in the Roth IRA will be tax-free at this point. On top of this all, a smaller traditional IRA balance means Medicare IRMAA surcharges are also lessened.

The RMDs would be taxed at their ordinary income tax rate, but considering the Roth conversions drive down the traditional IRA balance, the investor is left with $714,699 [($1,405,285 + 336,158)—$1,026,744)] more in assets had she not converted any monies to her Roth account.

At age 88, she is left with $336,158 in her traditional IRA, and a whopping $1,405,285 in her Roth IRA (tax-free)! This is $714,699 [($1,405,285 + 336,158)−$1,026,744] more than if she did nothing and followed the conventional wisdom as seen in the first example.

Assuming the aforementioned 24% income tax rate, the total tax paid by the investor of the traditional IRA with the Roth conversion of $17,500 per year would have been $256,929, but would have given her beneficiaries a tax burden of just $73,632 (as opposed to $238,366 in the example with no conversion).

Summary of examples

To summarize, by performing Roth conversions of $17,500 per year for 33 years upon turning 55, our investor would have a total of $1,741,443 between two accounts, while saving her beneficiaries a lot of money in taxes as opposed to having just $1,026,744 in her traditional IRA, which would be subjected to higher RMDs and creating a higher tax burden for our investor and potentially her heirs.

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